

Cash circulation and fundamental credit risk analysis

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Fundamental credit risk analysis typically relies on the analysis of the industry & business position along with the financial risk assessment. The financial risk assessment puts great focus on adjustments regarding the balance sheet, profitability and cash-flow. These adjustments aim at better reflecting the normative performance, economic and/or cash-flow reality, by stripping out certain exceptional items.

The cash-flow approach is very often considered through the assessment of the capital structure and bias in consolidation. There are many cases of aggressive accounting with the full consolidation of businesses which are only partially owned. This accounting treatment could lead to an erroneous interpretation of financial statements, specifically in the event the parent company is significantly indebted and is characterized by low capacity to generate cash-flow, and therefore relies on the ability to upstream cash within the group.

The cash-flow analysis does not only result from aggressive accounting methods nor just capital structure. As such, some businesses might be well integrated, fully owned and still be exposed to weak cash-circulation. While capital structure will be a great concern, especially for high-yield name, weak cash circulation could also be of great concern for investment grade names and specifically for multinational corporations (MNCs). This weak cash-circulation could result from legal & regulatory issues or organisation & weak treasury systems in place. A significant amount of cash on balance sheet coupled with a significant indebtedness can result from the difficulties of a parent company to repatriate the cash from its affiliate companies, due to either minorities, corporate structure, taxation, or even regulatory restrictions.

Following the outbreak of the Covid-19 pandemic, many corporates have seen their results sustained thanks to rather resilient activities - or even strong recovery - in Asia and China. Asia and China may have already been a significant contributor to the MNC growth over the recent past. Coronavirus may indeed have moved a little more the economic gravity centre from Occident to Orient.

With (i) MNCs generating even more EBITDA and cash-flow outside of their home country, (ii) the temptation for some countries to strengthen protectionist measures, and (iii) financial difficulties faced by some emerging countries which have been hard hit by coronavirus, the question as to how MNC's repatriate their cash might be moving back into the spotlight.

We have analysed a sample of companies composed of over 40 names operating in different sectors and geographies. Globally, the disclosures on cash restriction or localisation are very weak while the concentration of cash at the parent company level is around 50% (median value). Very few companies gave detailed information on their cash. The usual disclosure would highlight the presence of a centralized treasury management system for each jurisdiction & the legal

entity for which it is responsible, even though the cash concentration stands at around 50%. We consider this typical disclosure as rather weak. In the best disclosures, we have seen the mention of dedicated treasury companies with their name and localisation, the amount of cash concentrated at the level of parent/treasury companies or geographical area, or the amount of cash exposed to restrictions, with some disclosing the areas in which they face difficulties.

Based on the statistical analysis of our sample, we have not seen any particular link between the size of a group and its cash concentration, even though the larger groups would rely more on dedicated treasury companies. We think that this may reflect the fact that the larger groups tend to be more complex, with hundreds of subsidiaries, and more international, making cash repatriation more difficult. We have, however, seen some links between the rating and the cash concentration. The cash concentration for BB and investment grade companies stands at over 50% while it drops to below 25% for B rated companies, which probably reflects both the lower amount of cash on balance sheet and higher concentration of liquidity within the operation.

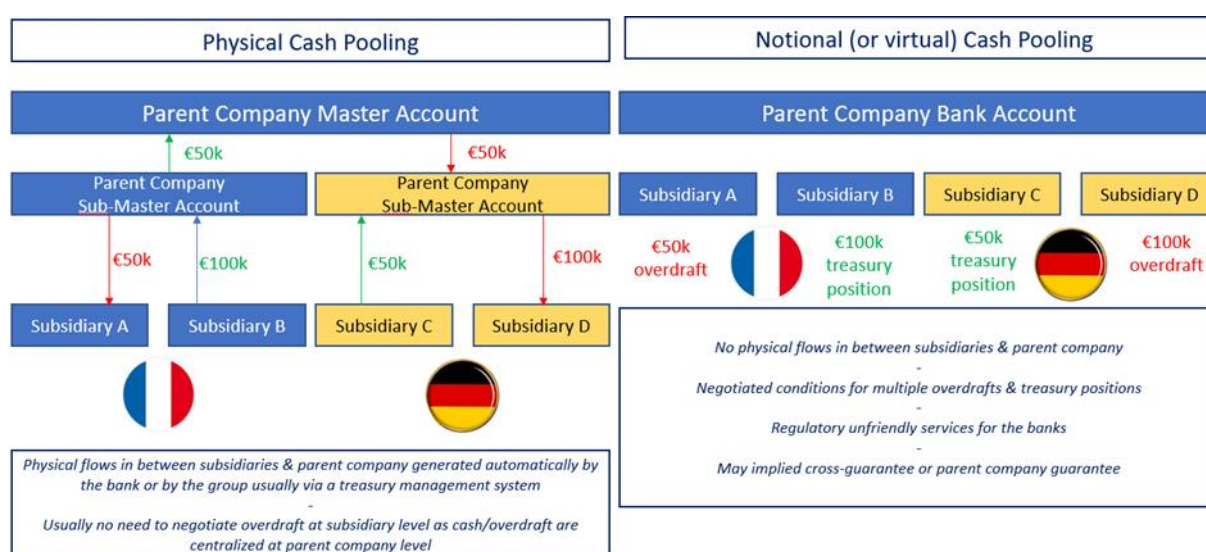
As regards countries presenting problems in this area, we have come across China, India, South Korea, Egypt, Morocco, Lebanon, Canada, Peru, Brazil, Chile and Colombia - all non-OECD except for Colombia, Chile, South Korea & Canada. This list is not exhaustive and subject to change. Basically, with these countries cash repatriation is complex and is subject to change of regulation. At the other end of the scale, US corporates faced difficulties to repatriate foreign dividends for many years and have benefited from a more favorable taxation since the implementation of the Tax Cuts and Jobs Act of 2017, which followed the 2004 repatriation tax holiday.

To repatriate their cash, MNCs have various options, none of which are perfect and may depend on the group structural organization and legal constraints. These solutions mostly consist in:

- Dividends: To repatriate their cash, the parent company can simply upstream dividends from their subsidiaries. On the positive side, the cash is upstreamed definitely, unlike with intra-group loans. On the negative side it might be subject to a long administrative process, specific taxation, or legal restrictions (such as minimum equity, minimum reserves, or distributable income). In certain countries it might even be subject to a complex approval system or even restrictions on the transfer of dividends offshore. Furthermore, it would not optimize intra-group financing given the potential evolution of capital requirements through the year, which will need to be financed with a minimum cash position and/or debt at the subsidiary level.
- Intra-group debt: To avoid the dividend process, it might be easier for corporates to finance their subsidiary with intra-group funds. This would fit rather well for a subsidiary typically under development and requiring cash to finance its development. As such, once the development and capital requirements come to an end, the subsidiary can start repaying its intra-group loan. Such reimbursement can be less

complex than dividend payments, even though this solution can be temporary until the loan is fully reimbursed. This solution might, however, still be exposed to transferability restrictions.

- Cash-pooling: In a cash-pooling arrangement, the cash is repatriated (or rather netted for virtual cash-pooling) on a frequent basis to the parent company (or dedicated treasury company), usually on a daily basis. Under such an arrangement, the cash circulation and group financings within the group are optimized with particularly a better meeting of daily needs. The cash-pooling can be operated by the group via a treasury management system or operated directly and automatically by the bank. We highlight below the two main cash-pooling services deployed by the banks for corporates: physical and notional (or virtual).



A physical cash-pooling will typically have a geographical organisation (or sometime currency organisation), with the cash pooled at a country level for each subsidiary. In our example, the cash is first pooled at the French scope (French submaster account level) and at the German scope (German sub-master account level) to be finally pooled at the master account level (such a master account can be in France or Germany but also in other jurisdictions such as for instance The Netherlands). Under the French scope, subsidiary A will receive €50k to cover its daily needs while subsidiary B will pull €100K, of which €50k will cover company A's needs and €50k will be pulled from the sub-master account in France to the master account level. In our example, the German pool would need to receive €50K from the master account. Consequently, the position of the master account is nil. The master account can benefit from an overdraft arrangement, meaning that the pool can cover its needs through its authorization under the overdraft. Usually, the overdraft would be required at the master account level and not at the subsidiary level. Obviously, the master account cannot exceed the limit set under its overdraft arrangement.

The physical cash-pool is the most efficient way to repatriate cash and to optimize intra-group financing and financing conditions. Indeed, the conditions negotiated by the master account are likely to be better than those negotiated on a standalone basis by a single subsidiary. Furthermore, such an operating scheme reduces dependence on external financing, given the greater reliance on intra-group financing, with likely daily optimization. We view the physical cash-pooling as credit-positive as the greater the centralization of debt and cash, the more transparent is the capital structure, the lesser are the structural subordination risks, and the better is the liquidity.

On the negative side, a cash-pooling system can be challenging to implement. The more complex the organisation (number of countries and number of subsidiaries specifically) and the more decentralized it is, the more complex it would be for it to implement and operate a physical cash-pooling. Furthermore, physical cash-pooling is usually not feasible for subsidiaries which are not fully consolidated. Such a physical cash-pooling will require the implementation of a cash-pooling agreement between the companies participating in the cash-pooling. It would also require the implementation of a cash-pooling agreement with the bank, in the event the pool is automatically operated by a bank. Under physical cash-pooling, the lending subsidiaries are exposed to the credit risk of the parent company and to the impact of a default within the pool. As such, some subsidiaries might be reluctant to participate under such a scheme and the banks might be reluctant to offer this service to subsidiaries and groups with a certain level of credit rating, or might be reluctant to incorporate this service to subsidiaries with negative equity and the like.

There is a certain link between the credit rating standing, the quality of the relationship the bank has with its customers, and the scope of the cash-pooling. Indeed, the cash-pooling structures may also face legal risks, such as the misuse of company assets and the misuse of power requiring the bank to have significant trust within the structure and among the participants. Usually, the implementation of automatic cash-pooling will be very difficult for companies under leveraged buy-out (LBO) as there is a risk that the treasuries of subsidiaries are upstreamed to repay the debt raised at the parent company level. It would be even more complex in the event the cash-pool bank participates within the financing of the LBO debt, given the bank might be facing a conflict of interest. Finally, the physical cash-pool is still constrained in certain jurisdictions by the transferability risk (total or complex) and/or dissuasive fiscal charges or administrative burden.

In the notional and virtual cash-pool, there is no exchange of funds. Usually, the parent company will negotiate group conditions for treasury excesses and overdrafts which will be applied to all the companies participating in the structure. The bank will implement overdrafts for each subsidiary and may request a cross-guarantee scheme or parent company guarantee to reduce its risk. Under such a scheme, the subsidiaries have greater autonomy than within the physical cash-pooling while a cash-pool agreement is still needed. The cash is, however, not centralized but the conditions are optimized. The bank might still be reluctant to offer a large overdraft to any single entity and might even be

penalized in terms of regulatory capital requirements. Furthermore, the situation might be complex at an international level given that banking regulations might be different and given that the presence of a bank in a certain country may be through a different legal entity rather than a branch. The notional cash-pool is still constrained in certain jurisdictions by the transferability risk (total or complex) and/or dissuasive fiscal charges if there is a regular clean-up requirement.

Usually, the cash management structure of a large group may rely on each of the systems we have described, which often can be complementary. As such, a large group can rely on a physical cash-pooling implemented between the subsidiaries of a specific country, which will enable it to better manage financing in this geography. However, the repatriation of its cash to its home country might be realized through annual dividends upstreamed, requiring specific authorization for the transfer of its funds, while with some other areas or divisions it may operate under a virtual cash-pool. Obviously, the more complex and international the group, the more diverse its cash repatriation scheme can be. The groups operating under multi-currencies, in multi-countries with multi-subsidiaries, and relying on automatic cash-pooling are usually the most sophisticated groups, typically blue-chips companies with longstanding relationships with their banks. As such, understanding the organisation of the cash management structure will help to understand the sophistication of the group and the challenges it is facing, which in turn helps to better assess the fundamental credit risk.